Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
In the Matter of Petition of WorldCom, Inc.	)	
Pursuant to Section 252(e)(5) of the	)	CC Docket No. 00-218
Communications Act for Preemption	)	
of the Jurisdiction of the Virginia State	)	
Corporation Commission Regarding	)	
Interconnection Disputes with	)	
Verizon Virginia Inc., and for	)	
Expedited Arbitration	)	
	)	
In the Matter of Petition of AT&T	)	
Communications of Virginia, Inc.,	)	CC Docket No. 00-251
Pursuant to Section 252(e)(5) of the	)	
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VERIZON VIRGINIA INC.'S APPLICATION FOR REVIEW

(Public Version)

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Dated: September 29, 2003

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VERIZON VIRGINIA INC.'S APPLICATION FOR REVIEW

Pursuant to 47 C.F.R. § 1.115(a), Verizon Virginia Inc. ("Verizon VA") respectfully submits this Application for Review of the Wireline Competition Bureau's August 29, 2003 Memorandum Opinion and Order (the "*Order*").[1/]

SUMMARY AND INTRODUCTION

The Commission should reverse the *Order*. The *Order* improperly prejudges decisions that are now pending before the Commission and adopts extreme assumptions and inputs that are

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1/ *See* Memorandum Opinion and Order, *Petitions of WorldCom, Inc. and AT&T Comm. of Virginia Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, CC Docket Nos. 00-218, 00-251 (rel. Aug. 29, 2003).

contrary to both Commission precedent and the record. Indeed, in order to reduce rates, the *Order* goes so far as to modify inputs *not* contested by any party, and in some cases adopts inputs that are more extreme than were proposed by any party and consequently produces rates that are lower than those proposed by any party. Moreover, the *Order* manipulates other inputs in a manner that state commissions have condemned as a way to "twice-TELRIC[]" rates by "double counting the TELRIC" reductions to expenses, and then goes on to effectively "triple TELRIC" those expense reductions. And the *Order* omits still other adjustments that even it recognizes are necessary. For all these reasons, the *Order* violates the Commission's rules and basic principles of administrative law.

As an initial matter, the *Order* prejudges major policy issues now under consideration by the full Commission and does so in ways that are inconsistent with existing rules. For example, the *Order* adopts a radical flat-rate structure for end office switching that is contrary to existing Commission precedent, that even AT&T did not support because it fails to properly align rates with costs, and that creates new subsidies from low usage customers to the high volume customers that CLECs typically target. The *Order* also requires that most non-recurring costs be recovered on a recurring basis, even though that too is contrary to existing rules and would force Verizon VA to serve as the CLECs' banker and to subsidize any CLECs that fail to retain customers long enough to pay off the loan.

Furthermore, the *Order* adopts radical assumptions that also are contrary to Commission precedent. To cite just a few examples, the *Order* assumes that more than 90% of all switching equipment can be purchased at new switch discounts of up to 99% off list price, even while simultaneously recognizing that no rational manufacturer could possibly offer such discounts if carriers bought predominantly new switches. The *Order* assumes that all fiber-fed loops in all

locations use integrated digital loop carrier even though no currently available technology permits the use of that technology to unbundle loops. The *Order* also sets high capacity loop rates that are not based on the costs of providing those loops, but instead are based entirely on unsubstantiated and demonstrably erroneous ratios between basic 2-wire loops and high capacity loops. The *Order* also adopts a non-recurring cost model that simply assumes away many of the tasks necessary for Verizon VA to process CLEC orders.

And the *Order* changes inputs that no party challenged and adopts inputs that are substantially more extreme than any party proposed. In the case of switching, for example, the *Order* sets the digital port fill factor at the same level as the analog port fill factor, even though *all* parties agreed that the fill factor for digital ports should be significantly lower than the fill for analog ports. The effect is to lower the costs of switching for fiber-fed lines substantially. Similarly, the *Order* significantly increases the total annual minutes of use over which investment is spread, and therefore reduces switching rates, by radically increasing the number of days that are assumed to experience peak usage in Verizon VA's studies. Yet *no* party challenged this input, and *no* alternative was proposed in the record.

The effect of these and other errors is to slash rates dramatically. For example, preliminary runs of cost studies show that the *Order* will produce end office switching rates that are by far the lowest in effect in any of the 31 jurisdictions where Verizon provides local service, roughly sixty percent lower than the existing rates that this Commission has found TELRIC-compliant, and result in the non-loop portion of the UNE-P being about one-third lower than what even AT&T proposed here. The residential UNE-P rate in zone 1, which is where approximately three-quarters of customers are located, is the *second lowest* in any Verizon jurisdiction for any comparable zone. The high capacity loop rates — which already benchmark

to New York — are cut by as much as fifty percent. And numerous non-recurring rates are either slashed or eliminated.

The *Order* does all of this even though the Commission found the existing rates in Virginia to be TELRIC-compliant less than one year ago in connection with its review of Verizon VA's 271 application. And those existing rates themselves are the product of significant reductions that were made to meet this Commission's benchmark standard compared to New York. Thus, the current rates *already* are equal to, and in the case of the so-called UNE-P, *lower* than, the corresponding rates in New York — a state that itself has applied TELRIC aggressively.

The Commission should not permit this continued race to the bottom. The *Order*'s determinations are in numerous respects contrary to applicable precedent and the record evidence, and are arbitrary and capricious. Moreover, although Verizon VA moved to permit the parties to supplement and update the record almost one year ago and subsequently filed a formal Proffer of Supplemental Evidence, the Bureau declined to consider it. As a result, the *Order* is based on a stale and incomplete record. Because of these errors, the *Order* increases existing subsidies and creates all-new ones for CLECs that rely on UNEs, thereby discouraging the development of facilities-based competition. Indeed, as a result of the prior rate reductions in Virginia, competitors already have shifted from their previous reliance on facilities they have deployed themselves to reliance on UNE-P at subsidized rates. The *Order* would significantly exacerbate that trend. For all these reasons, the *Order* should be reversed.

ARGUMENT

The *Order* moves in precisely the wrong direction. At a time when the Commission is trying to reform its rules to eliminate artificial subsidies in order to promote efficient

competition, the rates resulting from the *Order* would create new subsidies, increase existing ones, and thereby encourage reliance on Verizon VA's network rather than investment in competing facilities. It would be particularly irrational to implement the *Order* now because it pushes TELRIC to radical new extremes that are inconsistent even with existing rules and that further exacerbate the very flaws in TELRIC that the Commission has identified and is seeking to reform in its pending rulemaking. As Commissioner Martin has observed, "the Wireline Competition Bureau's interpretation of the TELRIC pricing rules in the recent Virginia Arbitration Order may not reflect the direction and spirit of today's decision" in the *TELRIC NPRM*.[2/]

In its *TELRIC NPRM*, the Commission explained that TELRIC embodies a "central internal tension" because it "purports to replicate the conditions of a competitive market by assuming that the latest technology is deployed throughout the hypothetical network, while at the same time assuming that this hypothetical network benefits from the economies of scale associated with serving all of the lines in a study area." *TELRIC NPRM* ¶ 50. The Commission noted that this internal inconsistency "may work to reduce estimates of forward-looking costs below the costs that would actually be found even in an extremely competitive market. It therefore may undermine the incentive for either competitive LECs or incumbent LECs to build new facilities, even when it is efficient for them to do so." *Id.* ¶ 51.[3/] The Commission further

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[2/] Notice of Proposed Rulemaking, *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, FCC 03-224 (rel. Sept. 15, 2003) ("*TELRIC NPRM*"), Separate Statement of Commissioner Martin at 1.

[3/] *See also id.* ¶ 3 ("To the extent that the application of our TELRIC pricing rules distorts our intended pricing signals by understating forward-looking costs, it can thwart one of the central purposes of the Act: the promotion of facilities-based competition.").

explained that the "excessively hypothetical nature of the TELRIC inquiry" renders it a "black box" that is "difficult to reconcile with our desire that UNE prices send correct economic signals." *Id.* ¶ 7. As a result, the Commission tentatively concluded that its "TELRIC rules should more closely account for the real-world attributes of the routing and topography of an incumbent's network." *Id.* ¶ 52.

The Commissioners themselves have echoed these conclusions. For example, Chairman Powell has correctly recognized that the TELRIC rules are "subsidized and below costs," "distort a competitor's decision whether to invest in new facilities," and need to be changed to "an approach grounded in the real-world attributes of the incumbent's network."[4/] Commissioner Martin has explained that the rules need to be adjusted to "more accurately reflect incumbent costs and help spur deployment in new facilities and services." *TELRIC NPRM*, Separate Statement of Commissioner Martin at 1. Commissioner Abernathy has pointed out that the current pricing standard is "excessively hypothetical," "sends inappropriate investment signals and produces irrational pricing." *Id.*, Separate Statement of Commissioner Abernathy at 1. And Commissioner Adelstein has acknowledged that the rules may need to be changed to "more closely account for certain real-world factors." *Id.*, Separate Statement of Commissioner Adelstein at 1.

Likewise, in a Policy Paper accompanying the *TELRIC NPRM*, Commission Staff has concluded that TELRIC requires reform in order to ensure appropriate cost recovery. As the paper states, "if investment costs are falling over time, and the period between TELRIC price adjustments is shorter than asset lives, then traditional TELRIC pricing will not permit

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[4/] Jeremy Pelofsky, *FCC Chief Denies Leaving, Outlines Media Agenda*, Star-Ledger, Aug. 19, 2003; *TELRIC NPRM*, Separate Statement of Chairman Powell at 1.

incumbents to recover the cost of their investment."[5/] And this shortfall is substantial: "When investment costs are falling by 11% per year (as is assumed for switching assets in the FCC Synthesis Model), the TELRIC correction factor is approximately *50%*. That is, switching prices should be increased by *50%* from those suggested by Synthesis Model runs." OSP Working Paper at 43.

Given all of this, it would be inherently arbitrary and capricious to endorse rates that not only are based on admittedly flawed rules, but that repeatedly are based on extreme approaches that are both inconsistent with existing rules and that inexorably drive rates lower still. This is especially true when the Commission found the existing rates to be TELRIC-compliant less than a year ago, and the *Order* would drive rates substantially below even TELRIC. Given that the existing rates already do not "send correct economic signals," "undermine the incentive for either competitive LECs or incumbent LECs to build new facilities," and are "below the costs that would actually be found even in an extremely competitive market," it would make no sense to reduce rates even more as the *Order* would do.

That is particularly true because the *Order* not only exemplifies the flaws in TELRIC that the Commission has identified, but goes beyond them. To take just one example, the *Order* assumes that 100% of all fiber-fed loops use IDLC-GR-303 technology even though, as the Commission has noted, "[e]ven if the objective is to replicate the results of a competitive market, an approach that reconstructs the network over time seems to be more appropriate than one that

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5/ David M. Mandy & William W. Sharkey, "Dynamic Pricing and Investment from Static Proxy Models," FCC, Office of Strategic Planning and Policy, OSP Working Paper Series No. 40, at 1 (Sept. 2003) ("OSP Working Paper"); *see also id.* at 1-2 ("Indeed, when investment costs are falling over time and TELRIC price reviews are conducted at intervals shorter than expected asset lives, the firm will earn less than its target rate of return under traditional implementations of TELRIC.").

assumes the instantaneous deployment of 100 percent new technology." *TELRIC NPRM* ¶ 68. But the *Order* wanders further into the hypothetical by basing this 100% IDLC-GR-303 input on the assumption that this technology can be used to unbundle standalone loops, based on the theory that it might be "technically feasible" to develop such a capability in the future, even though no such capability is yet "currently available" as the Commission's current rules require.

The *Order* further compounds TELRIC's inability to send appropriate economic signals through its refusal even to consider directly relevant supplemental evidence that Verizon VA sought to introduce almost a year before the *Order* was issued — evidence that would have showed that many of the assumptions on which the Bureau's *Order* is based are outdated and unsupportable.[6/] That evidence was critical to ensuring that the decision in this case was based on relevant and updated information. The market, legal, and regulatory landscapes changed dramatically in the nearly two years after the cost studies before the Bureau were completed (based on data that now is over three years old), and in the nearly year and one-half after the

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6/ *See* Verizon Virginia Inc.'s Motion to Permit Parties to Supplement the Record (Nov. 22, 2002); Verizon Virginia Inc.'s Proffer of Supplemental Evidence (Apr. 15, 2003) ("VZ-VA Proffer"). The *Order*'s suggestion that accepting Verizon VA's evidence would have resulted in delay, *Order* ¶ 21, is belied by the facts that the *Order* was issued almost a full year after Verizon VA's initial motion to permit the parties to supplement the record and that the *Order* has now expressly *invited* AT&T/WorldCom to submit additional record evidence concerning non-recurring costs. Similarly, the Bureau's insistence that it could not have considered Verizon VA's evidence without providing the parties and staff an opportunity for discovery and cross-examination, *id.* ¶ 23, is completely at odds with its apparent willingness to permit AT&T/WorldCom to devise and submit new cost proposals *without* providing Verizon VA an opportunity to respond. As the courts have explained, "[a]n agency acts arbitrarily and capriciously when it unjustifiably discriminates between similarly situated parties." *Ramapough Mt. Indians v. Babbitt*, Civ. No. 98-2136, 2000 U.S. Dist. LEXIS 14479, at *21 (D.D.C. Sept. 30, 2000).

hearings ended in this proceeding. By failing to consider relevant evidence, the *Order* exacerbated the current flaws in TELRIC and committed reversible error.[7]

In these circumstances, implementing the *Order* would be irrational and unlawful. For all the reasons outlined in Verizon VA's accompanying Stay Petition, the Commission should simply stay the *Order* until it reforms its TELRIC rules. But even if the Commission were to choose not to wait until its underlying rules are corrected, it should reverse the *Order* and make the numerous corrections necessary so that the resulting rates are at least as economically rational as the current TELRIC rules permit.

I. RECURRING COSTS

A. Switching

The *Order*'s determinations about switching costs prejudge issues pending before the full Commission and rest on extreme assumptions that are contrary to Commission precedent and the record. The result of the *Order* is to drastically slash switching rates so that they are the lowest in any of the thirty-one jurisdictions where Verizon provides service, roughly sixty percent lower than the level the Commission previously found TELRIC-compliant, and result in the non-loop portion of the UNE-P being about one-third lower than the rates AT&T proposed (and lower even than what WorldCom proposed as well). And this dramatic reduction produces a residential UNE-P rate in zone 1, where approximately three-quarters of the customers are, that is the second lowest rate in any Verizon jurisdiction for any comparable zone. These extremely

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[7] *See, e.g., United Mine Workers of Am. v. Dole*, 870 F.2d 662, 673 (D.C. Cir. 1989) (failure to supplement the record may raise serious doubts "about whether the agency chose properly from the various alternatives open to it"); *see also Radio-Television News Dirs. Ass'n v. FCC*, 184 F.3d 872, 888 (D.C. Cir. 1999) ("The FCC retains discretion to . . . reopen the record, to ensure that it fully accounts for relevant factual and legal developments . . . .").

low rates will only exacerbate subsidy flows to CLECs and further promote uneconomic reliance on Verizon VA's network at the expense of efficient facilities-based competition.

1. The *Order*'s Radical Approach to Switching Rate Structure Prejudges a Significant Issue Pending Before the Commission and Would Result in Subsidization of High-Usage Customers.

The *Order* adopts the most extreme proposal on the record with respect to the structure of local switching rates, and eliminates all minute-of-use charges for end office switching. *None* of the thirty-one jurisdictions in which Verizon provides service has imposed this flat-rate structure on Verizon, and even AT&T agreed that it does not properly align with costs. This decision is inconsistent with Commission precedent, *see* 47 C.F.R. § 1.115(b)(ii), and prejudges the very question pending in the *TELRIC NPRM* as to whether such a "change[]" in the rate structure would "comply with the statutory pricing standard under section 252(d)(1)." *TELRIC NPRM* ¶ 132. And it would create a whole new set of subsidy flows from low-volume users to-high volume users (and the carriers that serve them) at a time when the Commission is trying to eliminate such subsidies.

As an initial matter, the *Order*'s flat-rate switching structure is inconsistent with Commission precedent. As the *Order* recognizes, under existing rules, "incumbent LECs' rates for interconnection and unbundled elements *must* recover costs in a manner that reflects the way they are incurred."[8/] As the Commission has consistently recognized, a significant portion of switching costs are usage sensitive and thus recoverable on a minute-of-use basis. In the *Local Competition Order on Reconsideration*, for example, the Commission set usage sensitive

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8/ First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499, 15874 ¶ 743 (1996) ("*Local Competition Order*") (emphasis added); *Order* ¶ 458 (recognizing that under existing rules "UNE rates [must] be structured consistently with the manner in which the costs of providing them are incurred").

minute-of-use proxy rates for the switching UNE and expressly found that "the unbundled local switching element, as defined in section 251(c)(3), includes . . . the *usage-sensitive* switching matrix."[9/] In addition, the Commission's universal service Synthesis Model itself allocates 70% of switching costs to the minute-of-use category.[10/] Similarly, the Commission has repeatedly approved 271 applications in which significant portions of switching costs were recovered through a minute-of-use component.[11/] And the Commission likewise has concluded in the access charge context that switching costs are usage sensitive "and so should be priced on a usage-sensitive basis."[12/]

9/ Order on Reconsideration, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 13042, 13045 ¶ 6 (1996) ("*Local Competition Order on Reconsideration*"); *see also* 47 C.F.R. § 51.513(c)(2).

10/ *See* Tr. at 5211-12 (AT&T/WCom witness Ms. Pitts admitting that the Synthesis Model by default identifies 70% of switching costs as traffic sensitive and 30% as non-traffic sensitive).

11/ Memorandum Opinion and Order, *Application by Verizon Virginia Inc., Verizon Long Distance Virginia Inc., Verizon Enterprise Solutions Virginia Inc., Verizon Global Networks Inc., and Verizon Select Services of Virginia Inc., for Authorization to Provide In-Region, InterLATA Services in Virginia*, 17 FCC Rcd 21880, 21948-49 ¶ 121 (2002) ("*Virginia 271 Order*"); Memorandum Opinion and Order, *Application by Verizon New England Inc., Verizon Delaware Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization To Provide In-Region, InterLATA Services in New Hampshire and Delaware*, 17 FCC Rcd 18660, 18697-98 ¶ 61 (2002) ("*New Hampshire/Delaware 271 Order*"); Memorandum Opinion and Order, *Joint Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc. for Provision of In-Region, InterLATA Services in Alabama, Kentucky, Mississippi, North Carolina, and South Carolina*, 17 FCC Rcd 17595, 17641 ¶ 93 (2002) ("*BellSouth Five-State 271 Order*").

12/ Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, *Access Charge Reform Price Cap Performance Review for Local Exchange Carriers*, 11 FCC Rcd 21354, 21392-93 ¶ 73 (1996) ("*Access Reform NPRM*"); Order Terminating Tariff Investigation, *Iowa Telecomms. Servs., Inc.*, WC Docket No. 03-135, FCC 03-221 ¶ 4 (rel. Sept. 9, 2003) (allowing a traffic sensitive access rate for Iowa Telecom).

Likewise, here, all the parties agreed that at least a portion of switching costs are traffic sensitive and vary with usage. As Verizon VA explained, "[a] rate structure that captures both port and usage charges . . . is consistent with the way costs are incurred for circuit switching." Verizon Virginia Rebuttal Testimony of Harold E. West III at 2 (Aug. 27, 2001) ("VZ-VA Ex 115"). Verizon's switching cost studies thus identified 63.16% of switching resources as traffic sensitive. *See* Verizon Virginia Inc. Initial Post-Hearing Brief on Switching Issues at 16-17 (Jan. 17, 2002) ("VZ-VA Switching Br."). Even AT&T did not support a flat-rated switching charge and acknowledged that such a rate structure "does not properly align rates and costs." Direct Testimony of Robert J. Kirchberger on Behalf of AT&T at 15 (July 31, 2001) ("AT&T Ex. 4"). And WorldCom, which proposed the flat-rate approach, also confessed that at least some switching costs do vary with usage, and simply asserted that a flat-rate would be "easy to administer and audit."[13/] AT&T and WorldCom claimed that between 16 and 40% of switching resources were traffic sensitive. *See* VZ-VA Switching Br. at 17-18.

Likewise, the *Order* itself acknowledges that some costs are traffic sensitive and "vary with usage." *Order* ¶ 473. As it stated, for certain switching resources, "[t]he record supports a finding that the equipment for which these costs are incurred is a limiting resource and that congestion or blocking will occur as usage increases." *Id.* The *Order* found that usage sensitive costs could best be recovered through a peak-period rate structure, which would charge different MOU rates for usage during the peak calling period than during non-peak times, but noted that such a structure is difficult to implement. *See id.* ¶¶ 474-75. Yet, rather than attempt to correlate

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13/ Joint Initial Post-Hearing Brief of WorldCom, Inc. and AT&T on Switch Cost Issues at 26 (Jan. 17, 2002) ("AT&T/WCom Switching Br."); *see also* Direct Testimony of Chuck Goldfarb on Behalf of WorldCom, Inc. at 4 (July 31, 2001) ("WCom Ex. 5") (admitting that certain switching resources are designed in anticipation of peak period usage but proposing that they be recovered through a flat rate for administrative reasons).

cost causation and rates in the manner that Verizon VA and AT&T had proposed — through an average MOU rate — the *Order* simply abandons any pretense of setting cost causative rates at all.

In addition to being inconsistent with the Commission's own precedent, the *Order*'s determination also will create new subsidy flows in addition to those that already exist under TELRIC. Under a flat-rate structure, customers with below-average usage levels will subsidize customers with above-average usage levels, *see* VZ-VA Switching Br. at 20; VZ-VA Ex. 115 at 5 — precisely those customers that CLECs generally target.[14/] The *Order*'s suggestion that Verizon had not proven the existence of this subsidy wholly defies common sense. When a product or service is offered at a flat rate, high volume users obviously will benefit more than low volume users since high volume users will not pay more for the greater share of resources they consume. To take a simple example, customers who eat less at an "all-you-can-eat" buffet clearly subsidize customers who eat more.

The *Order*'s assertion that its admittedly "imperfect" solution is acceptable because Verizon VA offers a flat-rated calling plan to its *retail* users, *Order* ¶ 478, misses the point. Verizon VA's decisions regarding the rates it charges retail customers are not relevant to the

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14/ Statement of Betsy Bernard, AT&T Consumer Services President and CEO, *Q2 2002 AT&T Earnings Conference Call — Final*, Fair Disclosure Wire, Transcript 072302au.729 (July 23, 2002) ("Once we've entered a state, we design and target each offer to high-value customers to further improve the economics of the business."); *id.*, Transcript 072302au.742 (July 24, 2002) (David Dorman, Chairman and CEO, AT&T, noting that "AT&T consumer second quarter results demonstrate continued progress in expanding our product portfolio in new markets to attract and retain high-value customers. As we continue our transition from a standalone long distance company to a provider of [a] robust bundle of services, the bulk of our energy is being directed toward this high value segment, which represents a higher priority for us than the overall market share gains."); *id.* (Dorman noting that AT&T is "very, very focused on" the "high-value customer segment"); Legg Mason, *Telephone Wars: Local Competition Update* at 2 (May 22, 2001) ("The CLEC sales figures reflect larger market share gains than those calculated on the basis of line loss, since the majority of lines lost are of the high-usage commercial type.").

proper UNE rate structure. *See* VZ-VA Switching Br. at 21. Verizon VA decides whether to offer its retail customers flat-rated service or to charge them according to peak period usage based on its assessment of, among other things, the risks of underestimating average usage (and therefore underrecovering costs) and the attractiveness to the retail customer of paying a particular type of rate. CLECs can and should make those same business decisions. Their costs — in the form of UNE rates — therefore should reflect the way in which the underlying network costs are incurred, just as Verizon VA's do. A flat-rated structure clearly does not. Nor is there any basis to the *Order*'s argument that its structure is preferable because a flat rate avoids the problem of "estimating the minutes of use over which to spread [Verizon's] switching costs." *Order* ¶ 477. In fact, the *Order* provides just such an estimate with respect to determining a minute-of-use rate for tandem switching (although, as discussed below, its estimate is incorrect). *Id.* ¶¶ 454-57.

Finally, the *Order* also errs in deciding that switch processor costs do not vary with usage and therefore should be recovered through a flat-rate charge in any case. *See id.* ¶¶ 463-71. In fact, the costs of switch processing resources do vary with usage because they are sized based on expected usage: in other words, the size of the switch processor Verizon VA purchases — and therefore its cost — depends on how much traffic Verizon VA expects to traverse the switch.[15/] The Commission itself has noted that "the unbundled local switching element, as defined in

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15/ *See* Verizon Virginia Inc. Surrebuttal Testimony of David Garfield at 6-8 (Sept. 21, 2001) ("VZ-VA Ex. 123"); Verizon Virginia Inc. Recurring Cost Panel Surrebuttal Testimony at 176 (Sept. 21, 2001) ("VZ-VA Ex. 122"); VZ-VA Switching Br. at 19-20; Verizon Virginia Inc. Post-Hearing Reply Brief at 107-08 (Jan. 31, 2002) ("VZ-VA Reply Br.").

section 251(c)(3), includes . . . the *usage-sensitive* switching matrix," which includes the processing resources.[16/]

The two bases the *Order* cites for its contrary conclusion are contradicted by the record. First, the *Order* states that "modern switches typically have large amounts of excess central processor and memory capacity, [and therefore] the usage by any one subscriber or group of subscribers is not expected to press so hard on processor or memory capacity at any one time as to cause call blockage, or a need for additional capacity to avoid such blockage." *Order* ¶ 463. But the fact that Verizon VA's engineers accurately plan so that "the central processor and memory of a modern switch installed today are unlikely to exhaust as a result of increased subscriber usage," *id.* ¶ 468, does not show that processor costs are unrelated to usage levels: it simply shows that Verizon engineers are skilled at predicting such usage. As Verizon VA showed, switch processors include tools designed to decrease the chance of exhaust situations in case the engineers do *not* predict precisely. *See* VZ-VA Ex. 123 at 7-8. In any event, as discussed in more detail below in connection with the switch discount, Verizon VA does buy switching capacity in growth increments, including the replacement of and upgrades to switch processor equipment, and therefore increases switch capacity over time in response to increase in demand. *See* VZ-VA Ex. 122 at 176-87; VZ-VA Ex. 123 at 6-12. And though the *Order* notes that many of Verizon's upgrades to switch processors have been mandated by switch vendors, *see Order* ¶ 466, Verizon's witness explained that switch vendors mandate those upgrades to help carriers avoid exhaust situations. *See* VZ-VA Ex. 123 at 7-8.

16/ *Local Competition Order on Reconsideration* at 13045 ¶ 6; Verizon Virginia Inc. Rebuttal Testimony of Dr. Howard Shelanski at 26-27 (Aug. 27, 2001) ("VZ-VA Ex. 110").

Second, the *Order* nonsensically appears to reason that switch processor capacity is a fixed cost because Verizon pays switch processor costs up front (as part of so-called "getting started" costs). *See Order* ¶ 464. But *when* Verizon incurs processor-related costs does not determine whether those costs vary based on anticipated usage levels. As noted above, estimated usage determines the *amount* of costs Verizon VA incurs, and actual usage will determine whether additional costs must be incurred. Thus, switch processor costs are necessarily usage sensitive.

Thus, the *Order* fundamentally errs in adopting a flat-rate structure for end office switching charges. The Commission should reverse this decision and instead adopt Verizon VA's proposed rate structure under which 63.16% of Verizon VA's total switching investment should be recovered through a traffic sensitive minute-of-use rate, while the remaining 36.84% relating to the port should be recovered through a flat rate. *See* VZ-VA Ex. 122 at 191-97; VZ-VA Switching Br. at 16-17. As Verizon VA explained, it allocated port resources to the non-traffic sensitive rate and all other resources to the traffic sensitive rate, because every feature of the switch aside from the port is sized according to expected usage levels and potentially requires replacement or supplementation as usage increases. *See, e.g.*, VZ-VA Ex. 123 at 6. In granting Verizon's 271 applications in various jurisdictions, the Commission has approved very similar switching rate structures and has rejected CLEC arguments that TELRIC requires a greater allocation of switching costs to the non-traffic sensitive category.[17/]

17/ *See Virginia 271 Order* at 21947-49 ¶¶ 119-21 (rejecting AT&T's claim that the Virginia Commission's allocation of "getting started" costs to the traffic sensitive category constituted a TELRIC violation); Opinion and Order, *Application by Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization to Provide In-Region, InterLATA Services In Maine*, 17 FCC Rcd 11659,

2. The *Order*'s Switch Discount Assumptions Are Economically Irrational and Internally Contradictory.

The *Order* adopts a switch discount under which more than 90% of Verizon VA's vendor switching equipment is assumed to have been purchased at so-called "new switch" discounts, which are as high as *99%* off the list price. This outcome is inconsistent with the Commission's guidance on the appropriate switch discount assumption under TELRIC, makes no economic sense, and is contradicted by the *Order*'s own conclusions.

The *Order* adopts an "all new" discount for so-called "getting started" equipment — most of the switch processor resources — and a melded discount comprised of 85% to 88% new switch purchases for all remaining switching equipment. *Order* ¶¶ 403, 415. Together these decisions assume that more than 90% of all switching equipment is bought at "new switch" discounts. Moreover, the decision assumes that a carrier would purchase this 90% of its switching network at discounts of up to *99%* off the list price.[18/]

But as the *Order* itself recognizes, manufacturers would not offer high new switch discounts if carriers bought most switching capacity at new switch rates. As it expressly observes, "[i]f carriers did not typically grow their switches over time, it is unlikely that switch vendors would provide relatively large discounts on the initial switch investment." *Order* ¶ 386

11674-78 ¶¶ 26-30 (2002) ("*Maine 271 Order*") (approving the Maine Commission's allocation of 70% traffic sensitive and 30% non-traffic sensitive); Order No. 78552, *Investigation Into Rates for Unbundled Network Elements Pursuant to the Telecommunications Act of 1996*, Case No. 8879 at 64 (Md. Pub. Serv. Comm'n June 30, 2002) ("*Maryland UNE Order*") (adopting Verizon's proposed split of 61% traffic sensitive, 39% non-traffic sensitive); Tentative Order, *Generic Investigation Re Verizon Pennsylvania, Inc.'s Unbundled Network Element Rates*, R-00016683, at 145-46 (Pa. Pub. Util. Comm'n Oct. 24, 2002) ("*Pennsylvania Tentative Order*") (adopting Verizon's proposed split of 55% traffic sensitive, 45% non-traffic sensitive).

[18/] *See Order* ¶ 390 n.1018 (ordering Verizon to use the discounts it received for new switch purchases in 2000 as provided in response to a staff record request); Verizon Ex. 216P (providing information on discounts received for new switches).

n.1014. This is because "levels of new and growth switch discounts reflect vendors' judgments about anticipated purchases."[19/] Manufacturers make such discounts available because "efficient carriers do add to or grow their switches over time," *Order* ¶ 386, and thus much of switching capacity is purchased at "growth discounts," which typically are much lower than the new switch discounts. *See, e.g.*, Tr. at 2953-54 (Shelanski); VZ-VA Switching Brief at 9. As the D.C. Circuit has recognized, manufacturers offer substantial new switch discounts because that "locks in" carriers to purchase more expensive additions to that new switch.[20/] If carriers bought 90% new switches, rational switch vendors could not possibly offer extremely high discounts for new switches and still recover their costs. As the Commission argued to the D.C. Circuit and the court ultimately agreed, in "an ideal world where vendors can't lock telephone companies into their product" with the expectation of additional growth purchases, such deep new switch discounts would not exist.[21/]

Thus, if carriers used primarily new switches to deploy switching capacity, as the *Order* assumes, the current discounts unquestionably do not reflect the prices that would prevail. Under such a scenario, vendors inevitably would *increase* their prices for new switches due to higher demand. *See* VZ-VA Ex. 122 at 168-69; Tr. at 2953-54 (Shelanski). In order to remain

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19/ *See Order* ¶ 386 n.1014 (citing *BellSouth Five-State 271 Order* at 17635 ¶ 83; Memorandum Opinion and Order, *Joint Application by BellSouth Corp., BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Georgia and Louisiana*, 17 FCC Rcd 9018, 9059 ¶ 81 (2002) ("*Georgia/Louisiana 271 Order*").

20/ *See AT&T Corp. v. FCC*, 220 F.3d 607, 618 (D.C. Cir. 2000) (agreeing with the Commission's position that "growth additions to existing switches cost more than new switches *only because* vendors offer substantial new switch discounts in order to make telephone companies dependent on the vendors' technology to update the switches") (emphasis added).

21/ Oral Argument Tr. at 35, *AT&T Corp. v. FCC*, 220 F.3d 607 (D.C. Cir. 2000) (argued Apr. 24, 2000); *AT&T Corp.*, 220 F.3d at 618.

economically viable, manufacturers would still have to recover the same average per-line revenue even if the mix of new and growth purchases were different. This might be thought of as a form of "life cycle" cost for switching capacity, where the life-cycle price is the aggregate price that the switch manufacturer will try to recoup over the entire range of components it expects incumbents to purchase. The *Order,* while giving lip service to this theory, completely ignores it in adopting the switch discount assumption. This "[i]nternally inconsistent reasoning . . . is not entitled to any deference by the courts and is inherently arbitrary and capricious."[22/]

In addition to its erroneous approach to the switch discount generally, the *Order* specifically errs in its adoption of an all-new switch discount for switch processor equipment. This decision is contrary to the undisputed record evidence demonstrating that Verizon VA upgrades and grows the processor components of its switches — purchases for which Verizon does not receive the high new switch discount. *See* VZ-VA Ex. 122 at 176-78. The *Order* provides no rational basis for rejecting this evidence, finding only that "[t]o the extent that 'getting started' equipment is augmented or replaced for reasons other than growth, use of a discount other than the new switch discount to develop 'getting started' investment would result in rates that recover from current subscribers costs for future upgrades from which they receive no benefit today." *Order* ¶ 393. As Verizon explained, however, the upgrade growth purchases that it makes for processor equipment, such as to upgrade to newer technologies, is necessary for optimum switch operation *today* and therefore should be included in calculating switching costs. *See* VZ-VA Ex. 122 at 176-78.

[22/] *La. Fed. Land Bank Ass'n v. Farm Credit Admin.*, 180 F. Supp. 2d 47, 57 (D.D.C. 2001), *rev'd on other grounds*, 336 F.3d 1075 (D.C. Cir. 2003).

Instead of the *Order*'s irrational switch discounts, the Commission should adopt the discounts proposed by Verizon VA, which were based on Verizon VA's recent purchases and current contracts. In particular, Verizon VA asked each vendor to provide a list of all switching equipment purchases that Verizon made during year 2000, including the list prices and actual prices that Verizon paid. From this information, which was the most recent available data at the time the cost studies were done, Verizon VA calculated the effective discount that it actually received during the timeframe the purchases were made.[23/] As Verizon VA explained, this data reflects the mix of new and "growth" switches Verizon VA expects to purchase going forward to add capacity to its network and is the best objective measure of what manufacturers would offer in the way of a switch discount.[24/] These discounts reflect the revenues that Verizon's switch vendors expect to recover over the range of switch purchases they expect Verizon to make. And, as noted above, if Verizon VA were expected to buy more new switches and less growth equipment, then manufacturers would necessarily use a different pricing structure to recover more of their costs from new switches. Thus, the average cost of switching capacity would not change in a hypothetical TELRIC world. The Commission accordingly should adopt these discounts.[25/]

[23/] The effective discount was **[BEGIN VERIZON PROPRIETARY]** XXXX **[END VERIZON PROPRIETARY]** for Lucent and **[BEGIN VERIZON PROPRIETARY]** XXXX **[END VERIZON PROPRIETARY]** for Siemens. For Nortel, which accounts for less than 4% of switches in Verizon VA's network, the discount Verizon VA used in its switching cost studies is based on current contracts that the parties entered into in December 2000. Verizon VA used this information rather than the actual purchases for year 2000 because these contracts most accurately capture the latest material prices available to Verizon from Nortel.

[24/] Tr. at 5235 (Gansert); *id.* at 5230 (Matt); Verizon Virginia Inc.'s Recurring Cost Panel Direct Testimony at 189-94 (July 31, 2001) ("VZ-VA Ex. 107"); VZ-VA Ex. 122 at 166-71.

[25/] Alternatively, the Commission could use the discounts that Verizon VA submitted in response to a Staff record request during hearings, which captured the discounts Verizon

3. The *Order*'s Determination that All Switch Ports Should Be IDLC-GR-303 Is Contrary to the Record and the Commission's Rules.

The *Order* assumes that 100% of the fiber-fed loops in the forward-looking network use IDLC and that therefore switches use all IDLC-GR-303 digital line ports. This conclusion is wrong because it ignores the fact that IDLC-GR-303 cannot be used to unbundle standalone loops or to serve non-switched services, and that the network therefore must contain UDLC.[26/] The *Order*'s determination is flatly inconsistent with the Commission's rule that TELRIC rates must be based only on "currently available" technology, since IDLC-GR-303 is *not* currently capable of being used to provide unbundled loops. The *Order* therefore necessarily assumes that unbundled loops are provided using a technology that is not even capable of being used to unbundle loops and is fundamentally irrational. The percentages of the various types of DLC technology that are assumed for the forward-looking network are a "critical determination[]" for UNE costs, and the *Order* accordingly seriously understates switching costs. *Order* ¶ 303.

The *Order*'s finding that "[IDLC-GR303] loops are capable of being unbundled today," *id.* ¶ 310, is wrong. The Commission explicitly stated in the *Virginia 271 Order* that "it is not technically feasible to unbundle an IDLC loop." *Virginia 271 Order* at 21963-64 ¶ 148. The Commission similarly concluded in various section 271 orders that it is appropriate to base standalone loop costs on 100% UDLC, *BellSouth Five-State 271 Order* at 17625 ¶ 62, and

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received from its switching vendors over a five-year period. The effective discounts Verizon VA received during this time period is indicative of the overall discount Verizon might experience for a switch over its life. *See* VZ-VA Ex. 212; VZ-VA Switching Br. at 5-6. Verizon VA's proposal is quite conservative, since it includes relatively high discounts due to the end of the digital switch lifecycle.

26/ Fiber-fed loops are served over either UDLC (universal digital loop carrier) or IDLC (integrated digital loop carrier). IDLC can in turn use two different technologies — TR-008 or GR-303. UDLC-fed lines enter the switch using analog switch ports, while IDLC uses digital ports.